

1987

Proposed statement on auditing standards : the auditor's consideration of an entity's ability to continue in existence ; Auditor's consideration of an entity's ability to continue in existence; Exposure draft (American Institute of Certified Public Accountants), 1987, Feb. 14

American Institute of Certified Public Accountants. Auditing Standards Board

Follow this and additional works at: [https://egrove.olemiss.edu/aicpa\\_sop](https://egrove.olemiss.edu/aicpa_sop)

Part of the [Accounting Commons](#), and the [Taxation Commons](#)

---

### Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Board, "Proposed statement on auditing standards : the auditor's consideration of an entity's ability to continue in existence ; Auditor's consideration of an entity's ability to continue in existence; Exposure draft (American Institute of Certified Public Accountants), 1987, Feb. 14" (1987). *Statements of Position*. 496. [https://egrove.olemiss.edu/aicpa\\_sop/496](https://egrove.olemiss.edu/aicpa_sop/496)

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact [egrove@olemiss.edu](mailto:egrove@olemiss.edu).

**EXPOSURE DRAFT**

**PROPOSED STATEMENT ON  
AUDITING STANDARDS**

**THE AUDITOR'S CONSIDERATION OF AN ENTITY'S  
ABILITY TO CONTINUE IN EXISTENCE**

**FEBRUARY 14, 1987**

Prepared by the AICPA Auditing Standards Board  
For comment from persons interested in auditing and reporting

Comments should be received by July 15, 1987, and addressed to  
AICPA Auditing Standards Division, File 2363  
1211 Avenue of the Americas, New York, N.Y. 10036-8775

## SUMMARY

### Why Issued

Because businesses sometimes fail shortly after auditors have expressed unqualified opinions on their financial statements, the public has questioned whether auditors have assumed sufficient responsibility for evaluating the continued existence of an entity. The Auditing Standards Board is issuing this proposed statement on auditing standards to better serve the users of financial statements by requiring the auditor to evaluate continued existence in all audits and to modify the audit report when substantial doubt exists about an entity's continued existence.

### What It Does

According to the proposed Statement, an entity is a going concern when it has the ability to sustain its operations without entering into bankruptcy.

The proposed Statement would supersede SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*, and require the auditor to—

- Evaluate whether audit procedures performed identify conditions and events that raise a question about continued existence.
- Extend audit procedures when such conditions and events are identified to consider other factors and, if necessary, management's plans.
- Assess whether substantial doubt exists about an entity's ability to continue in existence when such conditions and events have been identified.
- Determine that the financial statements include adequate disclosure about possible discontinuance when the auditor has substantial doubt.
- Modify the audit report when substantial doubt remains about continued existence.

### How It Differs From Existing Standards

In contrast to SAS No. 34, the proposed Statement would—

- Require the auditor to consider continued existence in all audits.
- Require the auditor to modify the audit report when the auditor has substantial doubt about the entity's ability to continue, even if asset recoverability and liability classification are not in question.
- Eliminate "subject to" opinion qualification but still require report modification when the auditor has substantial doubt.

---

*This exposure draft has been sent to—*

- Practice offices of CPA firms.
  - Members of AICPA Council and technical committees.
  - State society and chapter presidents, directors, and committee chairmen.
  - Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.
  - Persons who have requested copies.
-



## American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, NY 10036-8775, Telephone (212) 575-6200

Telex: 70-3396, Telecopier (212) 575-3846

February 14, 1987

Accompanying this letter is an exposure draft of a proposed statement on auditing standards titled The Auditor's Consideration of an Entity's Ability to Continue in Existence.

Because businesses sometimes fail shortly after auditors have expressed unqualified opinions on their financial statements, the public has questioned whether auditors have assumed sufficient responsibility for evaluating the continued existence of an entity. The Auditing Standards Board is issuing this proposed Statement to better serve the needs of users of financial statements by requiring the auditor to evaluate continued existence in all audits and to modify the audit report when substantial doubt exists about an entity's continued existence.

When compared with the current audit requirements, SAS No. 34, The Auditor's Considerations When a Question Arises About an Entity's Continued Existence, this proposed Statement would change (1) the manner in which an auditor considers continued existence when applying audit procedures, (2) the circumstances in which the audit report is modified, and (3) the form of the report modification.

SAS No. 34 states that the auditor does not search for evidential matter relating to the entity's continued existence but must be aware that auditing procedures applied primarily for other purposes may bring to the auditor's attention information contrary to that assumption. The proposed Statement would require the auditor to consider whether conditions or events identified during the audit raise a question about the entity's ability to continue in existence. Thus, while no new audit procedures are required, the approach to evaluating evidential matter is changed to consider continued existence in all audits.

SAS No. 34 requires audit report modification for the recoverability, amount, or classification of assets and liabilities when they are affected by substantial doubt about continued existence. The proposed Statement would require an auditor to modify the report when substantial doubt exists about an entity's ability to continue in existence, regardless of whether recoverability, amount, or classification of assets and liabilities is affected.

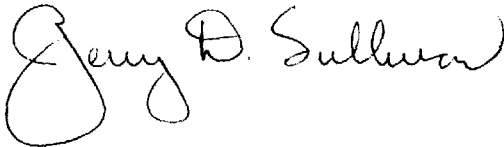
SAS No. 34 requires a "subject to" opinion qualification. The proposed Statement would eliminate the "subject to" opinion qualification for continued existence uncertainties as well as all other uncertainties and replace it with an unqualified opinion. However, the audit report would be modified to provide information about the substantial doubt about continued existence. A report modification for other uncertainties is illustrated in the appendix to the proposed statement on auditing standards titled The Auditor's Standard Report.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Auditing Standards Board's consideration of responses will be helped if the comments refer to specific paragraphs and include supporting reasons for each suggestion or comment.

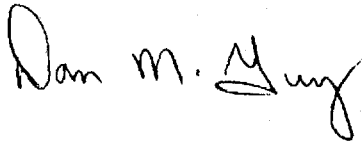
In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the Auditing Standards Division and will be available for public inspection at the offices of the AICPA after August 17, 1987, for one year. Responses should be sent to the Auditing Standards Division, File 2363, in time to be received by July 15, 1987. For convenience in responding, a perforated response form is attached and a postpaid return envelope is provided with this exposure draft.

Sincerely,

A handwritten signature in cursive script that reads "Jerry D. Sullivan". The signature is fluid and written in dark ink.

Jerry D. Sullivan  
Chairman  
Auditing Standards Board

A handwritten signature in cursive script that reads "Dan M. Guy". The signature is fluid and written in dark ink.

Dan M. Guy  
Vice President, Auditing

## PROPOSED STATEMENT ON AUDITING STANDARDS

### THE AUDITOR'S CONSIDERATION OF AN ENTITY'S ABILITY TO CONTINUE IN EXISTENCE

(Supersedes Statement on Auditing Standards No. 34, *The Auditor's Considerations  
When a Question Arises About an Entity's Continued Existence*)

1. This Statement provides guidance on the independent auditor's responsibility for assessing an entity's ability to continue in existence when making an examination of financial statements in accordance with generally accepted auditing standards.<sup>1</sup> It also provides guidance to the auditor when there is a question about an entity's continued existence. The guidance provided in this Statement applies to examinations of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.<sup>2</sup>

#### THE AUDITOR'S RESPONSIBILITY

2. The auditor has a responsibility when performing an examination in accordance with generally accepted auditing standards to consider conditions that exist and events that have occurred prior to the completion of fieldwork that might affect the entity's continued existence. The entity is normally viewed as a going concern that will continue in existence and will be able to sustain its operations without entering into bankruptcy proceedings or otherwise undergoing a similar transfer of operating control through regulatory or judicial action. In fulfilling this

responsibility the auditor is not responsible for predicting future conditions or events.

3. The auditor should consider whether conditions or events identified during the audit raise a question about the entity's ability to continue in existence. When such conditions or events have raised a question, the auditor should—

- a. Gather evidence to evaluate (1) other factors that might influence (either mitigate or aggravate) potential future effects of those conditions and events and, if appropriate, (2) management's plans for dealing with the pertinent conditions and events.
- b. Based on the above, assess whether substantial doubt exists about the entity's ability to continue in existence.
- c. Consider the adequacy of disclosures about possible discontinuance.
- d. Consider the need to modify the audit report.

#### AUDITING PROCEDURES

4. The following are examples of auditing procedures that may provide evidence that raises a question about continued existence:

- a. Applying analytical procedures
- b. Reviewing subsequent events
- c. Reviewing compliance with the terms of debt and loan agreements
- d. Reading the minutes of meetings of stockholders, board of directors, and other important committees
- e. Inquiring of an entity's legal counsel about litigation, claims, and assessments
- f. Confirming with related and third parties details of arrangements to provide or maintain financial support to those parties

- g. Obtaining written representations from management

#### CONDITIONS AND EVENTS THAT MAY RAISE A QUESTION ABOUT CONTINUED EXISTENCE

5. In performing auditing procedures such as those discussed in paragraph 4, the auditor may identify information about certain conditions or events that raise a question about continued existence. The following examples of such information vary widely in importance, and some may have significance only when viewed in conjunction with others.

- a. Information that may indicate solvency problems:
  - Negative trends (for example, recurring operating losses, working capital deficiencies, negative cash flows from operations, and adverse key financial ratios)
  - Other indications (for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, and necessity of seeking new sources or methods of financing)
- b. Information that may raise a question about continued existence without necessarily indicating potential solvency problems:
  - Internal matters (for example, loss of key management or operations personnel, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, and uneconomic long-term commitments)
  - External matters (for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to

<sup>1</sup> This Statement does not apply to an examination of financial statements based on the assumption of liquidation (for example, when (a) an entity is in the process of dissolution or liquidation, (b) the owners have decided to commence dissolution or liquidation, or (c) legal proceedings, including bankruptcy, have reached a point at which dissolution or liquidation is probable). See Auditing Interpretation, *Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting*.

<sup>2</sup> References in this Statement to generally accepted accounting principles are intended to include a comprehensive basis of accounting other than generally accepted accounting principles (excluding liquidation basis) as well.

operate; loss of a key franchise, license or patent; loss of a principal customer or supplier; and uninsured or underinsured catastrophes such as drought, earthquake, or flood)

### CONSIDERATION OF OTHER FACTORS

6. When conditions or events that have been identified raise a question about continued existence, the auditor should consider other factors associated with those conditions or events. Factors tending to influence (either mitigate or aggravate) the future effects of solvency-related conditions pertain primarily to an entity's alternative means for maintaining adequate cash flows. Examples of such factors include the following:

- a. Asset factors
  - Disposability of certain assets without disrupting necessary operations
  - Capability of delaying the replacement of assets consumed in operations or of leasing rather than purchasing certain assets
  - Possibility of using assets for factoring, sale-leaseback, or similar arrangements
- b. Debt factors
  - Availability of unused lines of credit or similar borrowing capacity
  - Capability of renewing or extending the due dates of existing loans
  - Possibility of entering into debt-restructuring agreements
- c. Cost factors
  - Separability of operations producing negative cash flows
  - Capability of postponing expenditures for such matters as maintenance or research and development
  - Possibility of reducing overhead and administrative expenditures
- d. Equity factors
  - Variability of dividend requirements
  - Capability of obtaining additional equity capital

- Possibility of increasing cash distributions from affiliates or other investees

7. Factors tending to influence conditions not necessarily concerning solvency relate primarily to the entity's capacity to adopt alternative courses of action. Examples are the availability of qualified persons to fill a vacated key position, the likelihood of effectively replacing a lost principal customer or supplier, the possibility of adequately replacing assets seized or destroyed, and the capability of operating profitably at reduced levels or of redeploying resources.

8. The auditor should perform auditing procedures to obtain evidence about the factors discussed in paragraphs 6 and 7. For example, the auditor might consider confirming arrangements made to renew or extend loans or examining relevant documents pertaining to the restructuring of debt. Also, evidence may be obtained through discussion with principal officers of the entity who have responsibility for administrative, financial, operational, and accounting activities.

### CONSIDERATION OF MANAGEMENT'S PLANS

9. If after considering other factors, the auditor believes there may be a substantial doubt about the entity's ability to continue in existence, then the auditor should consider management's plans for dealing with adverse conditions. In considering management's plans for mitigating the adverse conditions, the auditor should seek to obtain evidence that indicates a likely ability to mitigate the effects of adverse conditions for a reasonable period of time. A reasonable period of time would usually be up to a year beyond the date of the financial statements. The auditor's considerations relating to such management plans may include the following.

- a. Plans to liquidate assets
  - Apparent marketability of the assets that management plans to sell
  - Restrictions on the disposal of assets, such as covenants limit-

ing such transactions in loan or similar agreements or encumbrances against assets

- Possible direct and indirect effects of the disposal of assets
- b. Plans to borrow money or restructure debt
    - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit and arrangements for factoring receivables or sale-leaseback of assets
    - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
    - Possible effects on management's borrowing plans of existing restrictions on additional borrowing and the sufficiency of available collateral
  - c. Plans to reduce or delay expenditures
    - Apparent feasibility of plans to reduce overhead and administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
    - Possible direct and indirect effects of reduced or delayed expenditures
  - d. Plans to increase ownership equity
    - Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital
    - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investees

10. If prospective financial information is relevant to consideration of management's plans, the auditor should request management to provide that information and should consider the support for significant assumptions underlying prospective financial information. The auditor should give particular attention to assumptions that are—

- Material to the relevant prospective financial information.

- Especially uncertain or susceptible to change.
- Inconsistent with historical trends.

The auditor's considerations should include (a) reading of the prospective financial information and the underlying assumptions, (b) knowledge of the entity, its business, and its management, and (c) comparison of prospective financial information in prior periods with actual results and of prospective data for the current projection period with results achieved to date. If the auditor becomes aware of relevant factors, the effects of which are not reflected in such prospective financial information, he should discuss those factors with management and, if necessary, request revision of the prospective financial information.

11. When evaluating management plans, the auditor should identify those that are particularly significant to overcoming the effects of the adverse conditions and should design and perform auditing procedures to obtain evidence about such plans. For example, the auditor should consider the adequacy of support regarding the financial effects of leasing rather than purchasing assets, or should consider the support for planned disposal of assets.

### **ASSESSMENT OF ENTITY'S ABILITY TO CONTINUE IN EXISTENCE**

12. If, after he has considered management's plans to mitigate the adverse conditions, the auditor believes that substantial doubt remains about the entity's ability to continue in existence, consideration of financial statement effects is necessary and the auditor's report should be modified accordingly.<sup>3</sup> The longer the period of time that the entity is likely to continue in existence, the less likely it will be that the auditor can conclude that substantial doubt remains.

<sup>3</sup> If substantial doubt about continued existence does not exist, no special disclosures or audit report modifications are necessary. The auditor should be aware, however, of the loss contingency accounting and disclosure requirements of Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, paragraphs 8 through 12.

### **CONSIDERATION OF FINANCIAL STATEMENT EFFECTS**

13. When substantial doubt exists about the entity's ability to continue in existence, the auditor should consider possible effects on the financial statements. Although the historical cost basis remains appropriate (see footnote 1 for circumstances in which liquidation is imminent), the existence of substantial doubt may increase concern about the recoverability and classification of particular assets or the amounts and classification of particular liabilities. The auditor should also consider the adequacy of disclosures about possible discontinuance. Some of the information that might be disclosed includes—

- Pertinent conditions giving rise to the assessment of substantial doubt about continued existence.
- The possible effects of such conditions.
- Management's evaluation of the significance of those conditions.
- Other factors.
- Management's plans (including relevant prospective financial information).

Information about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities should also be disclosed if substantial doubt exists about those matters.

### **CONSIDERATION OF THE EFFECTS ON THE AUDITOR'S REPORT**

14. If the auditor concludes that there is substantial doubt about the entity's ability to continue in existence, the audit report should be modified to reflect that conclusion.<sup>4</sup> If appropriate, the modification should

<sup>4</sup> The board believes that the modification of the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this Statement, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph 13), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see SAS No. 2, paragraph 45).

indicate the uncertainty about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities.

15. An example follows of a report that has been modified for an uncertainty about continued existence when the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities is also in doubt.

In our opinion, the financial statements referred to above are, in all material respects, fairly presented in conformity with generally accepted accounting principles. These statements are based on the assumption of continued existence. As discussed in Note X to the financial statements, existing circumstances raise doubts as to the ability of Y Company to continue in existence. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities that might result from the possible inability of Y Company to continue in existence.

The audit report does not require an additional explanatory paragraph.

16. If the substantial doubt about continued existence does not affect the recoverability and classification of recorded assets and the amounts and classification of liabilities, the last sentence of the above audit report is not necessary.

17. If the auditor concludes that the entity's disclosures with respect to continued existence are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in SAS No. 2, *Reports on Audited Financial Statements*.<sup>5</sup>

18. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current

<sup>5</sup> This Statement would also amend SAS No. 2, paragraphs 21 through 26, regarding report modification because of uncertainties in general.



period, reporting guidance is provided in SAS No. 15, *Reports on Comparative Financial Statements*.<sup>6</sup> If a substantial doubt about the entity's ability to continue in existence becomes apparent in the current period, it does not imply that a basis

<sup>6</sup> Subsequent resolution in the current period of conditions or events that in a prior period had raised substantial doubt about the entity's ability to continue in existence may result in a report with an updated opinion different from the previous opinion. The reporting guidance provided in SAS No. 15, paragraph 6, for subsequent resolution of an uncertainty is appropriate in such situations.

for such doubt also existed in the prior period.<sup>7</sup> Accordingly, an uncertainty concerning continued existence—including an uncertainty about the recoverability and classification of recorded assets and the amounts and classification of liabilities in the financial statements—that arose in the current period does not

<sup>7</sup> SAS No. 15, paragraph 6, will be amended to add the following footnote to the second item:

See [this SAS] for guidance concerning the auditor's discovery of an uncertainty about an entity's ability to continue in existence.

ordinarily affect the financial statements of the prior period that are presented on a comparative basis. Furthermore, modification of the auditor's report on the current period's financial statements normally would communicate the nature and significance of the uncertainty adequately. Thus, the auditor ordinarily should modify his report on only the current period's financial statements because of the substantial doubt that arose in the current period about the entity's ability to continue in existence.

**Response Form Follows**

**FILE 2363**

TEAR ALONG DOTTED LINE

### Instructions for Response Form

**This perforated response form may be used for comments or suggestions relating to any aspect of the exposure draft that is of concern or interest to you. For convenience, the most significant points have been identified in the summary that accompanies this exposure draft.**

